

Identification & Assessment of Risks

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Risk Management for the Microfinance Sector:

Identification & Assessment of Risks

1) Risk Register Tool: An Introduction

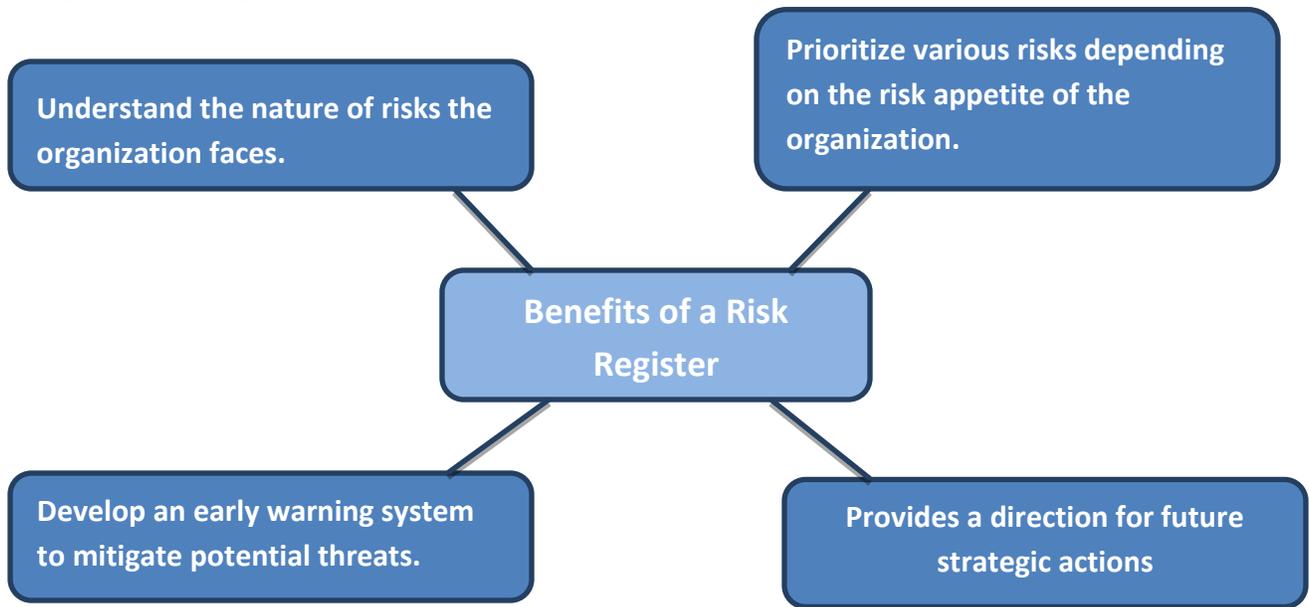
Risk is an inherent element of financial services, and like all financial institutions, microfinance providers (MFPs) face risks that they must manage effectively to achieve their financial and social objectives. It is imperative for microfinance providers to have a formal risk management structure in place to proactively establish processes that support business objectives while mitigating risks to an acceptable level.

The Pakistan Microfinance Network (PMN) has taken constructive steps to promote sound risk management practices amongst microfinance practitioners across Pakistan. As part of PMN's long term strategy to achieve sustainable growth in the Pakistan microfinance sector, PMN had launched first Risk Register for the microfinance sector in Pakistan in 2016 (Figure 1).

A risk register is a tool widely used by organizations for the identification and assessment of risks. The tool is considered a vital component of the risk management process as it serves as a central source for the organization's risk information and acts as a risk directory. It is used by organizations to list various risks, specifying the probability of occurrence and severity of impact, along with possible risk mitigation steps and strategies.

While the need for risk management has been identified as a priority by most MFPs for quite some time, the establishment of a risk management function is new in many organizations. PMN believes such a tool will enable MFPs (especially those with no existing risk management structures in place) to understand the nature of risks faced by the organizations at strategic and operational levels. The Risk Register will provide management and key stakeholders with significant information on diverse threats, which can be utilized to design risk management strategies to mitigate potential threats.

Figure 1: Risk Register

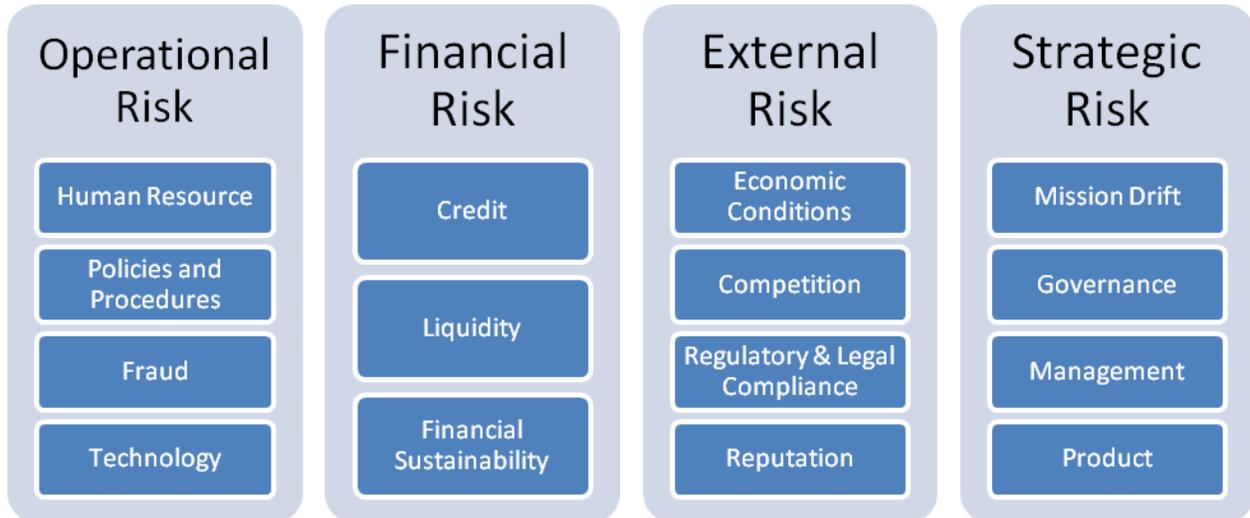


	Risk Statement	Probability of Impact	Severity of Impact	Existing Controls	Effectiveness of Controls	Planned Future Actions	Implementation Timeline
A	Operational Risk						
(i)	Human Resource Risk						
a	Hiring and Verification						
b	Training & Development						
c	Employee Retention						
(ii)	Policies & Procedures						
(iii)	Fraud Risk						
a	Field Staff						
b	Embezzlement						
(iii)	Technology						
a	Sophistication						
b	Integration						
c	Disaster Recovery						
B	External Risk						
(i)	Economic Conditions						
a	Security						
b	Interest Rate						
c	Natural Disaster						
(ii)	Competition						
(iii)	Regulatory & Legal Compliance Risk						
(iv)	Reputation Risk						
C	Financial Risk						
(i)	Credit Risk						
a	Due Diligence & Appraisal						
b	Monitoring/Recovery						
(ii)	Liquidity Risk						
(iii)	Financial Sustainability						
D	Strategic Risk						
(i)	Mission Drift						
(ii)	Governance						
a	Board of Directors						
b	Oversight						
(iii)	Management						
(iv)	Product Risk						

2) Structure of the Risk Register

The Risk Register focuses on four broad risk categories: Operational Risk, Financial Risk, External Risk and Strategic Risk. For each major risk category, the template further includes specific risk sub-categories as depicted in Figure 2.1:

Figure 2.1: Risk Sub-Categories



The potential threat faced by an institute from each sub-subcategory of risk is determined by the severity and probability of impact. Both measures are a vital component of the Risk Register, (shown in Figure 1), and are calculated by a combination of quantitative and qualitative risk indicators

For example, while computing financial risk, an MFP will have to measure the severity and probability of impact of each risk sub-category (credit, liquidity, and financial sustainability) for the organization.

This is achieved by measuring institutional attributes against a set of carefully drafted risk indicators unique to each sub-category. Figure 2.2 highlights the risk indicators used in the risk register to determine the severity and probability of *liquidity risk*.

The risk indicators used for each sub-category have been structured keeping in view global best practices and regulatory requirements pertaining to risk management, along with constructive input from industry practitioners.

Probability of Impact

The chances of suffering the consequences of the event, at any moment or over time.

Severity of Impact

The level of potential consequences of the event, at any moment or over time

Figure 2.2: Measurement of Liquidity Risk

PROBABILITY		Answer	Explanation	Risk Meter
1	Does the MFP have a formal set of policies to manage liquidity risk?	No		5
2	How frequently does the Asset Liability Committee (ALCO) review the liquidity position of the organization?	Quarterly		1
3	Does the MFP conduct a cash flow analysis/projections to monitor liquidity gaps?	Yes monthly		1
4	Does the MIS system of the organization have the capacity to calculate liquidity positions?	No		2
5	For funding purposes, the MFP has a working relationship with how many financial institutions?	Two or Three		1
6	Has the MFP ever been late or defaulted on its debt repayments?	None		0
7	The top management monitors and sets minimum limits on liquid assets?	None		2
8	Percentage of branches in which cash float is determined daily?	60% to 80%		1
9	The trend in PAR > 30 days over the last 12 months?	Stable		1
				78%
SEVERITY		Answer	Explanation	Risk Meter
1	What percentage of total funding is expected to mature within the next 12 months?	Greater than 70%		3
2	What is the Current Ratio (Assets maturing in less than one year/Liabilities maturing in less than one year) of the MFP?	Less than 1		0
3	What is the Debt Ratio of the MFP (Total debt/Total assets)?	Less than 40%		0
4	Does the MFP have a contingency funding plan in place in case of liquidity crises?	Yes		0
				38%

Risk Meter	< 30%	30% - 60%	> 60%
Impact	Low	Medium	High

3) Purpose & Outcome:

3.1) Objective of the Risk Register:

The development and distribution of the risk register to PMN members is based on a twofold objective:

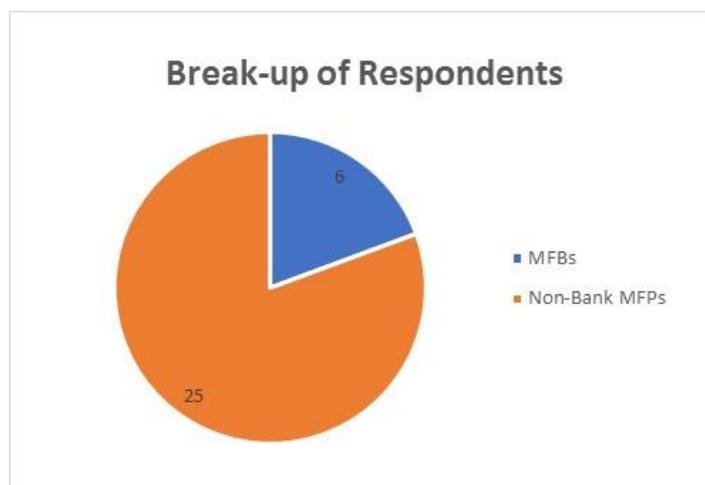
1. to encourage member organizations to use the Risk Register as an internal tool to strengthen their risk management function; and
2. to allow PMN to consolidate the data received from members through the template to create a sector-wide mapping of risks.

The consolidated information is utilized to formulate a *risk map* on which different risk categories are visually displayed (details to follow). The unification of risk indicators by PMN provides a holistic view of the sector's footing on risk management as weak and vulnerable areas are easily identifiable, along with emerging and potential threats. This information will prove beneficial while devising sector-wide risk mitigation strategies for long term sustainability and growth.

In terms of institutional strengthening, the Risk Register has the greatest utility for MFPs that are operating in the absence of any formal risk management structure. For such organizations (mostly non-bank MFPs), the tool serves as a stepping stone towards creating an effective risk management processes by facilitating the institutes in the identification and assessment of potential threats. It should be noted that a handful of top-tier microfinance providers have developed their own risk registers tailored to their organizational characteristics and complexities.

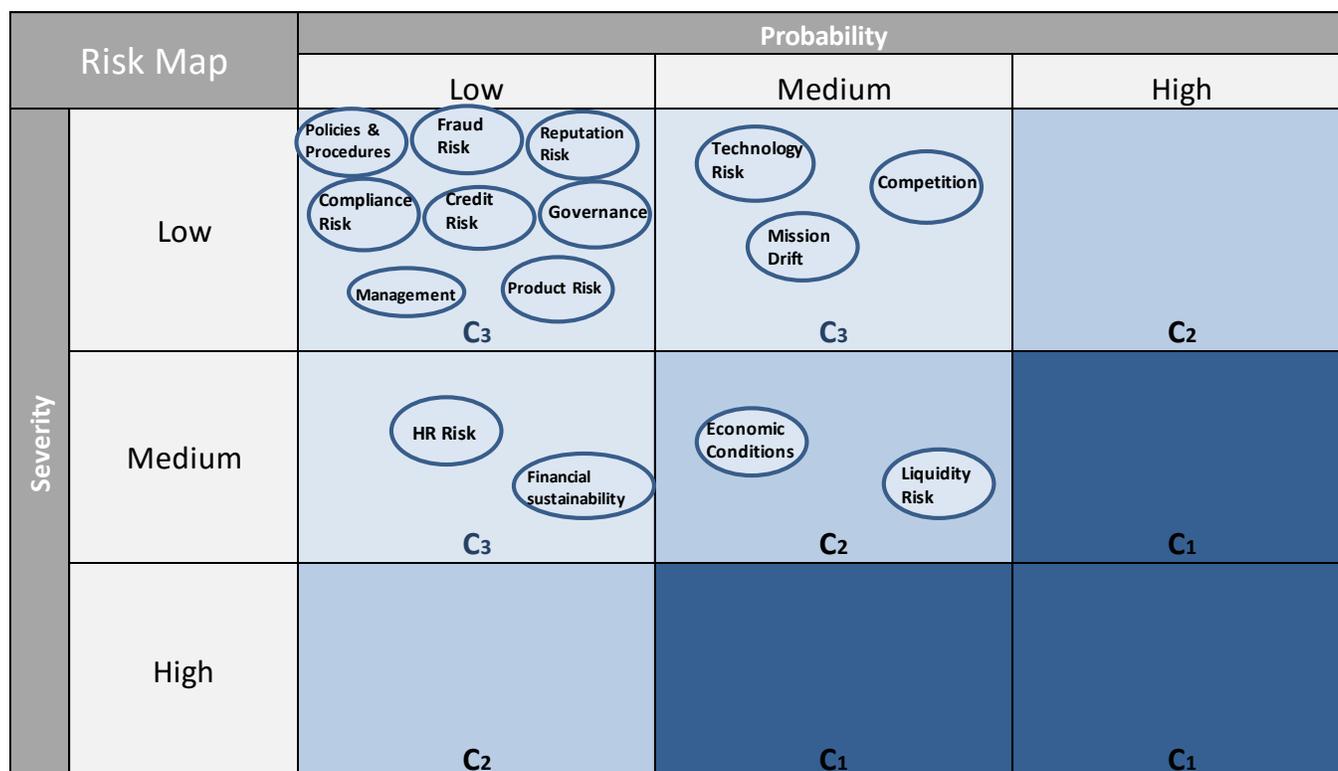
3.2) Mapping of Risk Indicators

The Risk Register was shared with all fifty members of PMN, of which, thirty-one members provided the completed template to PMN for sector evaluation purposes. Within the thirty-one respondents, six institutes were microfinance banks, while the remaining twenty-five institutes were non-bank microfinance providers (Figure 3.1). However, last year (2014) only twenty-four institutes provided the risk register template, out of which five were MFBs while nineteen were non-bank MFIs.



The risk indicators (derived from risk registers of the responding MFPs) were combined and plotted on a risk map, depending on their level of criticality. Prior to consolidation, each risk indicator was assigned a weight equivalent to the market share of the specific MFP. The following risk map shows the results of the combined risk registers of the sector:

Figure 3.2: Risk Map of the Microfinance Sector



Criticality Level		Risk Responses
C₁	High	Actions to reduce the frequency and severity of impact to be identified and implemented at the earliest.
C₂	Medium	Actions to reduce the frequency and severity of impact to be identified and implemented appropriately in the near term.
C₃	Low	To be kept on watch list – no action is needed unless grading increases over time.

The key findings from the sector risk map are that the risk indicators are essentially distributed in the low and medium category (in terms of level of criticality), of which, majority indicators fall in the low category, which bodes well for the sector.

On comparison with last year’s sector’s risk map, it is observed that *economic conditions* indicator, which was the only indicator under high criticality category in last year’s mapping, has moved to a

medium category in current year. Moreover, probability of impact of two sub-categories of financial risk (financial sustainability and credit risk) has been reduced from medium to low category in current year in comparison to the last year. These developments depict that on a yearly basis overall risk being faced by the sector has been relatively subdued.

For a more detailed analysis, the results from the consolidated risk registers were bifurcated into two key peer groups; MFB peer group and non-bank MFP peer group. The following two risk maps present the results of each peer group:

Figure 3.3: Risk Map of Non-bank MFP Peer Group

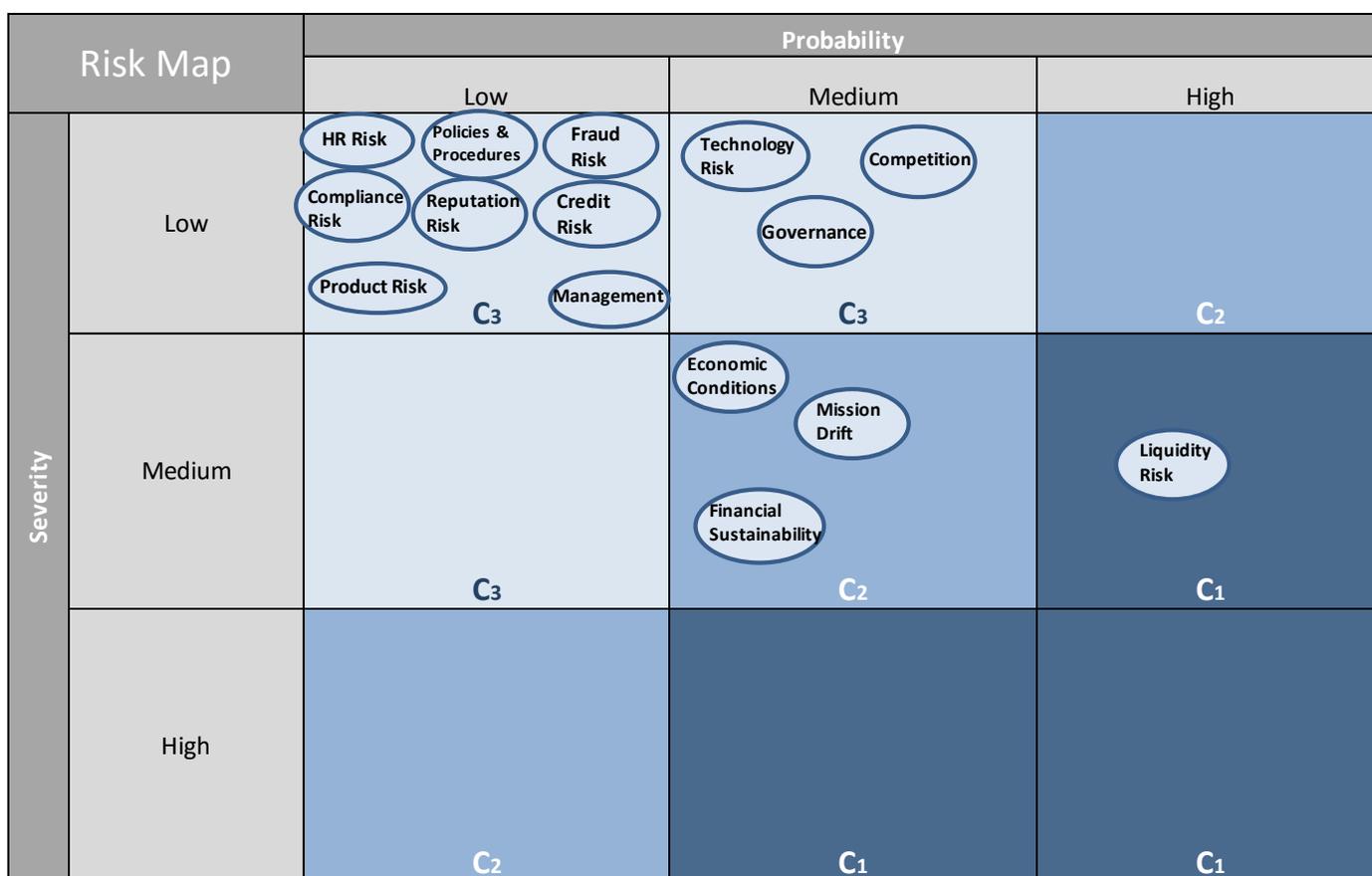
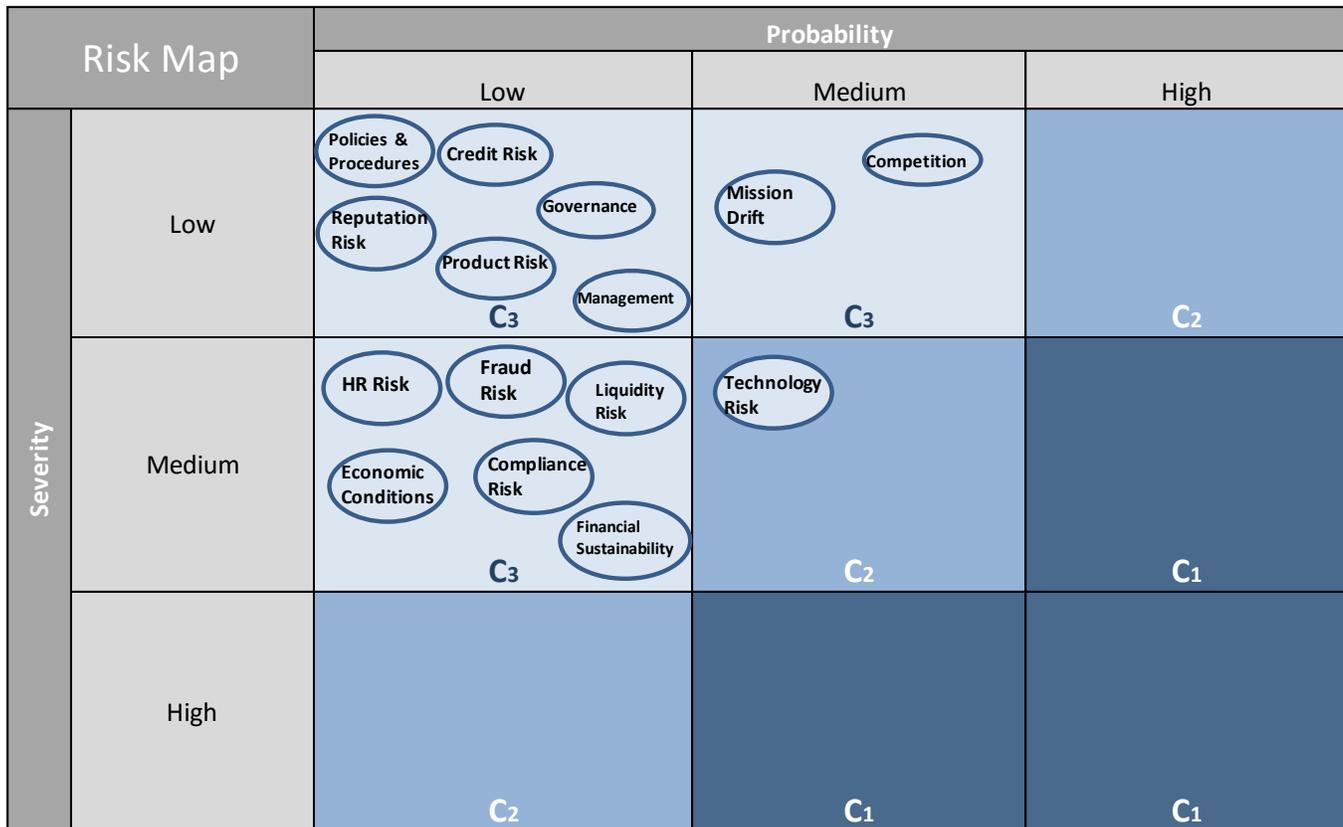


Figure 3.4: Risk Map of MFB Peer Group



The risk map for the non-bank MFP peer group displays risk arising from *liquidity issues* as the greatest threat for majority of Microfinance Institutes (MFIs) and Rural Support Programs (RSPs). Resultantly, constructive steps need to be taken in the short run to reduce the severity and probability of impact from such risks. Moreover, non-bank MFPs need to take appropriate measures to reduce the severity of *economic conditions*, *mission drift*, and *financial sustainability* - fall in the medium criticality category.

Nevertheless, comparison with previous year reveals that non-bank MFPs have managed to mitigate HR and credit risk – shifted from medium category in last year to low criticality category in 2015. However, probability of impact of *governance* has increased from low to medium category during the current year, which raises concern.

The risk map for the MFB peer group depicts a slightly different picture; no risk indicator is positioned in the high criticality category. Although financial risk for MFBs is comparatively a less significant threat, severity of risk of two sub-categories (financial sustainability and liquidity) is under medium category, which needs to be mitigated. Nevertheless, comparison with last year's risk mapping depicts that MFB peer group has managed to mitigate the probability of impact of various indicators – *HR risk, Fraud risk, economic conditions, and liquidity risk* – by shifting from medium to low category during the period under review.

4) Future Actions:

Going forward, PMN aims to promote the use of the Risk Register by all its member organizations and increase the number of entities reporting for the risk register.

Based on the findings of the risk register, the perils being faced by the industry shall be discussed at the PMN's Risk Forum and capacity building of MFPs shall be organized to mitigate these risks as part of PMN's Center of Excellence.

In addition, PMN is aggressively working on setting up an industry wide Disaster Risk Fund. This will assist the players in mitigating risk from natural calamities like floods, earthquakes and drought. Setting up a disaster risk fund shall allow MFPs to continue working in areas which are disaster prone. Moreover, this initiative would lead players to concentrate on expansion and continued growth in outreach with affecting their sustainability.